Internal Revenue Service
memorandum
CC:TL-N-8760-91
RLOverton P+S I

date: OCT 22 1991

to: District Counsel, Manhattan CC:MAN
Attn: Ms. Carmen M. Baerga

from: Assistant Chief Counsel (Field Service) CC:FS

subject: [redacted]

This responds to your request for assistance in connection with the above-mentioned case. By memorandum dated July 17, 1991, you requested our views with respect to the following issues.

ISSUES

1.(a) If the characterization of the [redacted] ("Agency") as the issuer of the [redacted] series municipal bonds is respected, whether the taxpayer's ([redacted]'s) liability to the Agency should be recognized as legally extinguished (defeased) when funds are placed by the Agency, pursuant to an Escrow Agreement, in an irrevocable trust established to redeem the bonds.

(b) If the taxpayer's liability to the Agency is legally defeased upon placing funds in an irrevocable trust, whether the taxpayer is entitled to deduct the excess of the redemption price over the adjusted issue price of the Agency Note in the tax year it places sufficient funds in an irrevocable trust established to redeem the [redacted] series municipal bonds.

(c) If the taxpayer's liability to the Agency is legally defeased upon placing funds in an irrevocable trust, whether the taxpayer is entitled to deduct the remaining unamortized [redacted] bond issuance expenses which expenses would be reflected in the adjusted issue price of the Agency Note.

2.(a) Based on the assumption that in substance the taxpayer is the primary obligor on the [redacted] series bonds, whether the taxpayer's liability with respect to these bonds should be recognized as legally extinguished (defeased) when funds are placed by the Agency, pursuant to the Escrow Agreement, in an irrevocable trust established to redeem the bonds.

(b) If the taxpayer's liability with respect to the [redacted] series municipal bonds is legally defeased upon placing the funds in an irrevocable trust, whether the taxpayer is entitled to deduct the excess of the redemption price over the adjusted issue

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price of the bonds in the tax year it places sufficient funds in an irrevocable trust established to redeem those bonds.

(c) If the taxpayer's liability is defeased, whether the taxpayer is entitled to deduct the remaining unamortized issuance expenses of the [redacted] series municipal bonds in the tax year the funds are placed in an irrevocable trust.

3. Whether the Agency or the taxpayer is entitled to a current deduction or must amortize the expenses related to the issuance of the [redacted] series taxable municipal bonds.

RECOMMENDATION

Assuming that the [redacted] is respected as the issuer of the [redacted] series municipal bonds, we conclude that [redacted]s obligation to the Agency was legally extinguished upon the funding of the escrow account as per the terms of the Trust Agreement. Therefore, [redacted] is entitled to deduct in [redacted] a redemption premium (the excess amount paid by the taxpayer to redeem the Agency Note prior to maturity), claimed as a defeasance loss by the taxpayer. Although the taxpayer would not be entitled to deduct the remaining unamortized expenses of issuing the [redacted] bonds directly as the issuer of the bonds, the taxpayer would in effect receive a deduction for these expenses as a redemption premium since these expenses were netted against the bond proceeds loaned to the taxpayer from the Agency. That is, the issue price of the Agency Note would be adjusted to take into account these expenses, thereby increasing the amount of the redemption premium deduction subsequently realized.

However, if, as the taxpayer asserts, we respect the taxpayer as being in effect the primary obligor on the [redacted] series bonds, then we conclude that the taxpayer's obligation with respect to the [redacted] series bonds was extinguished upon the funding of the escrow account by the Agency, as per the terms of the Escrow Agreement. Therefore, the taxpayer is entitled to current deductions in [redacted] for the redemption premium, claimed as a defeasance loss by the taxpayer, as well as the remaining unamortized issuance expenses related to the issuance of the [redacted] series municipal bonds.

Finally, regardless of the disposition of the defeasance issue, only the party considered to be the issuer of the [redacted] series taxable municipal bonds (the taxpayer or the Agency) can amortize the expenses associated with the issuance of the [redacted] series bonds and must amortize them over the life of the bonds.

FACTS[1]

In [redacted], taxpayer [redacted], a partnership, borrowed funds from the Agency and issued a nonrecourse note for $[redacted] to the Agency to finance the construction of [redacted] facility. To acquire the funds to lend to [redacted], the Agency issued tax-exempt municipal bonds in the face amount of $[redacted] for sale to the public through an underwriter. The bonds were limited obligations of the Agency (i.e., nonrecourse), payable solely from the loan payments received from [redacted].

Specifically on [redacted], prior to issuance of the bonds ([redacted] revenue bonds), the Agency entered into a Trust Agreement with [redacted] acting as Trustee, under which the Agency agreed to issue the revenue bonds and loan the proceeds to [redacted] to finance the [redacted] facility. The loan between [redacted] and the Agency (the "Agency Loan Agreement") was evidenced by a nonrecourse note ("Agency Note") requiring [redacted] to make payments sufficient to pay, when due, the principal, interest and any premium on the bonds. [redacted] secured its obligations under the Agency Loan Agreement by assigning to the Agency its rights under a lease agreement between it as owner\lessor of the facility, dated as of [redacted], and [redacted] the operator\lessee, to the revenues derived from the operation of the facility. In addition, [redacted] assigned its rights under other contracts relating to the operation of the facility.

The [redacted] series bonds were issued under and secured by the Trust Agreement by and between the Agency and the Trustee [redacted]. Under the Trust Agreement, the Agency pledged or assigned to the Trustee all its rights in the Agency Loan Agreement, the Agency Note, and various funds and contract rights assigned to it by [redacted] (owner\lessor) as security for the equal and ratable benefit of the holders of the [redacted] series bonds. In addition, the Trust Agreement provided that the Agency could issue additional bonds under certain terms and conditions which would be equally secured with the [redacted] series bonds and subject to the terms and conditions of the Trust Agreement. Moreover, the bond form and the bond coupon form provided that the [redacted] series bonds and interest thereon were the limited obligations of the Agency, payable solely from the revenues derived from the facility and assigned to the Agency by [redacted] (owner), under the Agency Loan Agreement and the Agency Note. The bond form stated

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[1] The facts are gathered from your memorandum requesting assistance dated July 17, 1991, the Trust Agreement dated [redacted], the Agency Note, the [redacted] series bonds issuance package, and the Refunding Escrow Agreement.

that the Agency was not obligated to pay the [redacted] series bonds or the interest thereon <u>except from the revenues of the facility</u>.

The Trust Agreement provided for the optional redemption of the bonds by the Agency, exercised upon the discretion of the owner upon not less than forty-five days notice by the Owner ([redacted]) to the Trustee, on or after [redacted], in whole or in part on any interest payment date, at the following redemption prices expressed as percentages of the principal thereof, plus accrued interest thereon to the redemption date:

Redemption Dates	Redemption Prices
[redacted] through [redacted]	.... [redacted]%
through [redacted]	.... [redacted]%
through [redacted]	.... [redacted]%
through [redacted]	.... [redacted]%
through [redacted]	.... [redacted]%
through [redacted]	.... [redacted]%
through [redacted]	.... [redacted]%

Article VIII of the Trust Agreement also allowed, however, for defeasance of the bonds as follows:

ARTICLE VIII

DISCHARGE OF LIEN

> Section 801. <u>Discharge of the lien of the Trust Agreement</u>. When all of the bonds and coupons appertaining thereto shall have been paid, or deemed paid as provided in Section 802 hereof, . . . then the lien of this Trust Agreement, these presents and the rights hereby granted shall cease, terminate and be void, and thereupon the Trustee shall cancel and discharge this Trust Agreement and execute and deliver to the Agency such instruments in writing as shall be required to discharge this Trust Agreement and assign and deliver to the Agency any property at the time subject to the Trust Agreement which may be in the possession or subject to its control, . . .
>
> Section 802. <u>Bonds and Coupons Deemed Paid</u>. Bonds and the coupons appertaining thereto shall be deemed to have been paid within the meaning of Section 801 hereof . . . when, for payment of the principal thereof and interest thereon to the due date thereof . . . the Trustee shall hold . . . as Paying Agent for such payment (a) moneys sufficient to make such payment or (b) moneys and government obligations (hereinafter defined) maturing as to principal and interest in such

> amount and at such times as will insure the availability of moneys to make such payment . . .

In addition, the bond itself provided that no notice of optional redemption shall be given unless sufficient funds for such redemption are on deposit with the Trustee and designated for redemption.

In [redacted], [redacted], a wholly owned subsidiary of [redacted] purchased a [redacted]% interest in [redacted] [redacted] had used the proceeds from the [redacted] series bond issuance to construct [redacted] facility ("[redacted]). At the time of the acquisition of the interest in [redacted] by [redacted], [redacted] created another partnership, [redacted] to build a [redacted] facility. [redacted] was granted the right to construct [redacted] facility provided it acquired and updated the [redacted].

In order to finance the construction of [redacted] facility and to pay off the [redacted] series bonds issued by [redacted] the Agency issued [redacted] series [redacted] bonds. This series was issued for the express purpose of providing [redacted] with the necessary funds with which to pay off the [redacted] series bonds. The face amount of the [redacted] series bonds was $[redacted].

On [redacted], an Escrow Refunding Agreement ("Escrow Agreement") was executed between the Agency, [redacted] and [redacted], as Escrow Agent under the Escrow Refunding Agreement and as Trustee under the Trust Agreement. The purpose of the Escrow Agreement was to satisfy [redacted]s obligations incurred with respect to the above discussed bonds. In accordance with this agreement, the Agency, upon request of [redacted] concurrently issued [redacted] series [redacted] bonds in the face amount of $[redacted] and deposited the funds obtained into an escrow account with the [redacted] The funds were used to purchase United States Government obligations which would generate enough interest when combined with the principal to pay off the [redacted] series bonds as they were redeemed from [redacted] through [redacted].

The Escrow Agreement provided that in order to provide for full payment until maturity or redemption of the [redacted] bonds and defease the Trust Agreement pursuant to section 801 thereof, a special fund would be established and funded with the proceeds from the [redacted] bond issuance. These funds were to be held by the Paying Agent of the Escrow Account ([redacted] for the exclusive benefit of the holders or the registered owners of the [redacted] series bonds. Under the Escrow Agreement these funds were subject to the same trusts and liens in favor of the [redacted] bondholders as pertains to funds in the hands of the Paying Agent under the Trust Agreement. In addition, the Escrow Agreement further provides that should any excess funds exist after payment of the [redacted] series bonds, said excess funds shall be distributed by the Paying Agent to [redacted]

Section 6 of the Escrow Agreement provides that upon funding the escrow account [redacted] was released from all obligations to pay principal and interest installments and other payments due under the Agency Loan Agreement or the Agency Note as defined under the Trust Agreement with respect to the [redacted] bonds. Concurrently with the execution of the Escrow Agreement and as per the terms of the Trust Agreement, the trustee canceled and returned the Agency Note to [redacted].

In [redacted] deducted, as current expenses, the unamortized portion of the [redacted] bond issuance expenses. [redacted] also deducted as a current expense, the difference between the face value of the [redacted] series taxable municipal bonds and the issue price of the [redacted] series municipal bonds, an amount of $[redacted] as a defeasance loss.

The position of the taxpayer is that upon the funding of the escrow account with the proceeds from the issuance of the [redacted] series bonds (in accordance with the provisions of the Trust Agreement, specifically Sections 801 and 802, and the Escrow Agreement), its obligation secured by the Agency Note, to pay off the [redacted] series bonds was legally "defeased" or extinguished. Therefore, the taxpayer maintains that the unamortized [redacted] bond issuance expenses, and the redemption premium paid to redeem the [redacted] series bonds prior to maturity, were currently deductible in [redacted].

DISCUSSION

Treas. Reg. § 1.163-4(c) provides that, for obligations issued after May 27, 1969, if the "bonds are issued by a corporation and are subsequently repurchased by the corporation at a price in excess of the issue price plus any amount of the original issue discount deducted prior to repurchase, or minus any amount of premium returned as income prior to repurchase, the excess of the repurchase price over the issue price adjusted for amortized premium or deducted discount is deductible as interest for the taxable year." (Emphasis added.)

The central issue in this case is whether the taxpayer's obligation is extinguished. The Service has addressed this question in a situation concerning who should be taxed on income from securities placed in a trust to satisfy a corporation's obligation with respect to its bonds. In Rev. Rul. 85-42, 1985-1 C.B. 36, the Service stated the necessary requirements for an obligation to be defeased for purposes of Treas. Reg. § 1.61-13(b). In that revenue ruling, a corporation had contributed Government securities to an irrevocable trust to satisfy the scheduled payments of principal and interest on an outstanding bond issue of the corporation. Any amount remaining in the trust after the corporation's bonds were retired was to revert to the corporation. Although the possibility that the corporation would be required to make future payments on the bonds was remote, the corporation was not legally released from being the primary obligor on the outstanding bonds. The revenue ruling concluded that the corporation could not be considered to have discharged the debt owed to its bond holders upon the transfer of assets to the trust because the corporation was not legally released from being the primary obligor on the bonds.

Issue 1(a)

Respecting the Agency as the issuer (obligor) of the bonds, as recognized by Rev. Rul. 85-42, the taxpayer's principal obligation is its obligation on the note to the Agency. Accordingly, the relevant issue is whether [redacted] was released from being the primary obligor on the Agency Note. The Agency, as per the terms of the Escrow Agreement, funded the escrow account with the proceeds of the [redacted] bond issuance. Under the Escrow Agreement, specifically Section 6, the Paying Agent, acting also as Trustee under the Trust Agreement, upon funding of the escrow account released and discharged the lien of the Trust Agreement and discharged [redacted] from all obligations to pay principal and interest and other payments due under the Agency Loan Agreement and the Agency Note as defined under the Trust Agreement with respect to the [redacted] series bonds. The Trustee then canceled and returned the Agency Note to [redacted]. Although [redacted] could yet have certain liabilities under the Escrow Agreement as to any excess funds returned to [redacted] by the Paying Agent upon redemption of the bonds, we think that due to the rights reserved to the Trustee to discharge the lien and the Agency Note upon the funding of the escrow account, the primary obligation of [redacted] on the Agency Note as per the Trust Agreement, and any liability [redacted] may have had to the [redacted] series bondholders, was legally discharged. As such, the Agency Note should be deemed to have been repurchased for an amount in excess of its issue price under Treas. Reg. § 1.163-4(c).

Issue 1(b)

Since the Agency Note is deemed to have been repurchased, thereby discharging [redacted]'s liability under the note, the redemption premium (claimed as a defeasance loss by [redacted] representing the excess of the redemption price over the adjusted issue price is currently deductible as interest. Treas. Reg. § 1.163-4(c). See also, The 12701 Shaker Boulevard Company v. Commissioner, 36 T.C. 255 (1961); Rev. Rul. 57-198, 1957-1 C.B. 94. The interest is currently deductible even if the redeemed borrowings are replaced with new financing as in the instant case. 12701 Shaker Boulevard Company, supra. Under Treas. Reg.

§ 1.163-4(c), the repurchase premium for bonds issued after May 27, 1969, is specifically deductible as interest.

Issue 1(c)

[redacted] cannot deduct the bond issuance expenses of another entity, the Agency. Yet, the remaining unamortized issuance expenses from the [redacted] series bonds would be effectively deductible by [redacted] in [redacted] (the year the escrow account was funded to redeem the [redacted] series bonds), as part of the redemption premium, by way of the excess amount paid over the adjusted issue price of the Agency Note, based on the presumption that the adjusted issue price of the note takes into account the issuance expenses by netting these expenses against the bond proceeds to determine the amount loaned to [redacted]. Therefore, the remaining unamortized [redacted] issuance expenses would be deductible by [redacted] indirectly as part of the redemption premium paid to redeem the Agency Note prior to maturity. Treas. Reg. § 1.163-4(c).[2]

Issue 2(a)

The taxpayer has apparently treated itself as the primary obligor with respect to the [redacted] series bonds. Assuming that [redacted] is the primary obligor with respect to the [redacted] series bonds, our position is that [redacted]'s liability on the bonds was legally extinguished (defeased) upon the funding of the irrevocable trust by the Agency as per the instructions of [redacted] under the Escrow Agreement. This position assumes that the Agency is a mere conduit or agent for the issuance of the [redacted] series tax-exempt municipal bonds and that the primary liability for the bonds lies with [redacted]. This assumption is certainly viable due to the fact that the only obligation with respect to the bonds was that of [redacted], as the owner of the property securing the bonds, i.e., the facility (and operating contracts) to be constructed and owned by [redacted]. The purported liability of the Agency was limited solely to the payments to be received from [redacted]. The Agency Note executed between the Agency and [redacted] was nonrecourse and secured by a pledge or assignment of the revenues to be derived from the operation of the facility. Hence, the argument can be made that

[2] Treas. Reg. § 1.163-4(c) provides, in pertinent part, that if bonds are issued by a corporation and are subsequently repurchased by the corporation at a price in excess of the issue price adjusted for amortized premium or deducted discount, the excess is deductible as interest. In the instant case, [redacted] would adjust the issue price of the Agency Note to take into account the issuance expenses netted against the bond proceeds loaned to it by the Agency. The face amount of the loan would remain the same but the issue price would be adjusted to reflect the expenses netted out and amortized over the life of the bonds.

the primary liability which existed with respect to the bonds rested with [redacted]. Therefore, upon the funding of the irrevocable trust with the proceeds of the [redacted] bond issuance to be used to redeem the [redacted] series bonds and the subsequent release of [redacted] from all liability (i.e., the liens on its property) on the bonds by the Trustee, [redacted]'s primary liability with respect to the bonds was legally discharged.

Issue 2(b) and (c)

Hence, if [redacted] is considered to have been the primary obligor on the [redacted] series bonds, it would be entitled to a current deduction in [redacted] for the redemption premium paid to redeem the [redacted] series bonds. This premium, representing the excess of the redemption price over the adjusted issue price would be currently deductible as interest. Treas. Reg. § 1.163-4(c). See also, The 12701 Shaker Boulevard Company v. Commissioner, 36 T.C. 255 (1961); Rev. Rul. 57-198, 1957-1 C.B. 94. The interest is currently deductible even if the redeemed borrowings are replaced with new financing as in the instant case. 12701 Shaker Boulevard Company, supra. Under Treas. Reg. § 1.163-4(c), the repurchase premium is specifically deductible as interest.

Furthermore, if [redacted] is considered to have been the primary obligor on the [redacted] series bonds the remaining unamortized issuance expenses from the [redacted] series bonds would be currently deductible in [redacted] (the year the escrow account was funded to redeem the [redacted] series bonds), even though the old bonds were retired with the cash proceeds from a new issuance. See, San Jaoquin Light & Power Company v. McLaughlin, 65 F.2d 677 (9th Cir. 1933). Expenses of issuing bonds, including commissions paid, should be treated like discount and if not already deducted are deductible in the year of retirement. Union Pacific Railroad Company v. Commissioner, 293 U.S. 282 (1935); Rev. Rul. 70-353, 1970-2 C.B. 39; Rev. Rul. 70-359, 1979-2 C.B. 103. Therefore, the remaining unamortized issuance expenses were deductible in [redacted].

Issue 3

However, regardless of whether you choose to respect the Agency as the issuer of the [redacted] series taxable municipal bonds or characterize [redacted] as the primary obligor on the bonds, only the issuer can amortize the expenses associated with the issuance of the bonds and must amortize them over the life of the bonds. Rev. Rul. 70-353, 1970-2 C.B. 39, provides that issuance expenses and a proper proportion of the bond discount or premium is amortized over the life of the bonds. See also, Rev. Rul. 70-359, 1970-2 C.B. 103. In addition, if the Agency is respected as the issuer of the [redacted] series bonds, we recognize that [redacted] might have amortizable issuance expenses associated with the issuance of another note to the Agency assuming use of the same transaction structure as was used for the issuance of the [redacted] series bonds.

CONCLUSION

Assuming you respect the characterization of the Agency as the issuer of the bonds, our position is that [redacted]s primary obligation under the Agency Note was extinguished upon the funding of the escrow account in [redacted] as per the terms of the Escrow Agreement and the Trust Agreement. Therefore, [redacted] would be entitled to a redemption premium, representing the excess of the redemption price paid over the adjusted issue price of the Agency Note. This amount would be properly deductible as interest under Treas. Reg. § 1.163-4(c). In addition, [redacted] would effectively be entitled to deduct the amount of remaining unamortized issuance expenses reflected in the adjusted issue price of the Agency Note and deductible as part of the redemption premium.

If you agree with the implicit assumption that in substance [redacted] was the primary obligor on the [redacted] series bonds, [redacted] would be entitled to current deductions in [redacted] for the redemption premium paid and the remaining unamortized issuance expenses from the issuance of the [redacted] series bonds.

Nevertheless, only the issuer can amortize the expenses associated with the issuance of the [redacted] series taxable bonds and must amortize them over the life of the bonds.

DANIEL J. WILES

By: Clifford M. Harbourt
CLIFFORD M. HARBOURT
Senior Technician Reviewer
Income Tax & Accounting Branch
Field Service Division